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Memorandum

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SUBJECT **:** Proposals for Changing the IFIs

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This memorandum provides information about the international financial institutions (IFIs) – particularly the comparative roles and functions of the World Bank and International Monetary Fund – and recent suggestions for changing the functions of these international agencies. These include the proposals voiced by Treasury Secretary Lawrence Summers in December 1999 and March 2000 and the recommendations made by the congressionally-appointed International Financial Institutions Advisory Commission ("Meltzer Commission") in early March 2000. The memorandum makes some comparisons between the proposals set forth by Secretary Summers and the Meltzer Commission and it identifies some premises or issues that might merit further consideration.

The Functions of the IMF and World Bank

As originally conceived by their creators, at the international financial conference at Bretton Woods, New Hampshire in 1944, the IMF and World Bank had distinct roles. The IMF was to be a monetary, not a development, institution. It would oversee the world's international payments and exchange rate systems, provide financial assistance for countries experiencing sustained balance of payments deficits, help maintain an open world trading system, and avoid a return to the kinds of "beggar thy neighbor" currency devaluations that exacerbated tensions during the inter-war period. The International Bank for Reconstruction and Development (IBRD), by contrast, would be a major source of capital for war-damaged and developing countries, promoting reconstruction and economic development through loans as well as through policy and technical advice. The IBRD's logo, "World Bank," subsequently became the common name for the international institution.

The context for the international agencies changed in later decades. During the 1970s, the system of fixed parity exchange rates collapsed and most countries went onto some type of floating or pegged exchange rate system. Since 1979, the IMF has lent almost solely to developing countries, as the more advanced countries – with flexible exchange rates and strong central banks that act as lenders of last resort – have found they do not need to borrow from the IMF to deal with balance of payments problems. As the world economy was roiled by two oil price increases, several serious recessions, and a chronic debt and development crisis in many countries, the IMF raised the limit on the amounts that countries could borrow and it created new loan instruments to deal with particular situations. Previously, the IMF loans were repayable over a three-to-five year period at an interest rate based roughly on the rates that developed country governments pay when they borrow money in commercial markets. In the 1970s and 1980s, the IMF lengthened the repayment period for some of its loans to 10 years – the Extended Fund Facility -- and it created a new low-interest loan program– the Enhanced Structural Adjustment Facility (ESAF) – to help its poorest member countries borrow on concessional terms. The latter program has been renamed recently and is now called the Poverty Reduction and Growth Facility (PRGF). The IMF also placed more emphasis in its loan conditions ("conditionality") on promoting basic reform in its borrower countries' economic policies and institutions.

The World Bank also broadened its focus during the decades after its creation. In 1956, the International Finance Corporation (IFC) was created to help small private sector firms in developing countries get access to capital without a need for government guarantees. In 1960, the Bank created its concessional loan facility – the International Development Association (IDA) – to provide low-income countries with access to World Bank assistance on repayment terms they could afford. In 1988, the Bank's member countries also established the Multilateral Investment Guarantee Agency (MIGA) in order to encourage the flow of foreign investment into developing countries through investment guarantees protecting investors against non-economic risk (expropriation, for example) and through agreements with host country governments clarifying their rules on foreign investment.

Before 1980, the World Bank mainly lent to finance particular projects. Until the late 1960s, it focused mainly on the construction of economic infrastructure; thereafter, an increasing share of its loans supported health and education projects and other social sector programs aimed at the alleviation of poverty. In the early 1980s, the World Bank began lending an increasing share of its funds for Structural Adjustment Loans (SALs) or Sector Adjustment Loans (SECALs) which aimed at promoting basic economic reform in borrower countries. From the perspective of many observers, it appeared that the IMF and World Bank were focusing on similar types of issues – economic policy reform, economic stabilization, and institutional change – in the same types of countries. Others maintained, however, that the Bank and Fund were performing different – though increasingly interrelated – functions in the execution of their respective mandates.

Proposals for Change: the Meltzer Commission

In the past several years, many analysts have suggested ways the IMF and the World Bank might be restructured. These have ranged from proposals that the two agencies be privatized or abolished to suggestions that they be merged or fundamentally refocused. The most recent proposal has come from a congressionally-appointed panel, the International Financial Institutions Advisory Commission. It is often called the Meltzer Commission, named after its chairman, Professor Allan H. Meltzer. The Commission released its report on March 8, 2000, recommending major shifts in the organization and functions of the IMF and the World Bank. The report was approved by an 8-3 vote of the Commission's membership. A sharply dissenting minority report was filed by 4 members of the Commission. (One member signed both the majority and minority reports.)

The Commission said the functions of the IMF and the World Bank should be redrawn to avoid overlap. With more clearly specified and limited goals, the Commission argued, the international agencies will be more accountable and effective in their operations. The changes would be phased in over a five year period. The Commission did not say, however, how the transition would be accomplished or how weak countries would be prepared to operate successfully in the new system.

The Future of the IMF. The Commission recommended unanimously that the IMF should stop making loans for the purpose of development or poverty alleviation. In particular, its should eliminate the PRGF and EFF. Rather, IMF lending would be restricted to short-term liquidity assistance. Financing countries' long-term recovery would be the province of the multilateral development banks (MDBs). To qualify in advance for crisis assistance, countries would need to show the IMF that foreign financial institutions have free entry into their economies (an existing WTO provision), that they regularly publish information on the size and structure of their foreign official debt, that they have sound fiscal policies, and that their national banking and financial systems are sound and conform to internationally recognized prudential standards. Many developing countries may have difficulty meeting these standards. In such situations, the Commission says the IMF should lend freely, on a senior creditor status and at penalty rates of interest (higher than the rates the country normally pays when it borrows in commercial markets.) The IMF should encourage member countries to adopt institutions and policies that are likely to reduce the possibility and/or the magnitude of a financial crisis and it would then lend for short term liquidity needs when appropriate. The IMF should distinguish between solvent countries that are suffering from a bonafide liquidity shortfall and insolvent countries or countries that merely want access to low-cost credit in order to repay their private creditors or to fund their national budgets. The Commission says the IMF should reserve its assistance for the first category of countries. These requirements could be waived, the Commission said, in situations where the global financial system was at risk due to a crisis affecting a country that was otherwise unable to qualify for regular IMF loans.

The Future of the MDBs. The Meltzer Commission proposed that the World Bank lend only to countries that are unable to borrow from private markets and it should aim to convert itself into a grant-making anti-poverty agency. The Commission published figures showing that 78% of the World Bank Group's non-concessional aid (i.e., IBRD loans, IFC loans and investments, and MIGA investment guarantee coverage) in the past 7 years had gone to countries whose credit ratings give them access to private loans. In many cases, the Commission said, the volume of private loans going into these countries was many times the amount provided through the auspices of the World Bank. Moreover, the Commission reported that some 64% of the World Bank group's non-concessional aid in the past 7 years has gone to support activities "directly profitable to the private sector." The Commission argues that Bank-funded activities are "directly profitable to the private sector" when they supports activities that a private firm might undertake with its own resources or operate on behalf of governments, with or without subsidies, or when the Bank channels resources into state firms or privatization programs or into major roads or other major transport or communications facilities.

The Commission recommends that the IFC and MIGA should be abolished and the World Bank should stop lending to any country able to borrow on commercial markets. This would substantially reduce its lending. In addition, it should turn over to the Inter-American Development Bank (IDB) and Asian Development Bank (ADB) all responsibility for development lending in their areas of operation. The World Bank should also withdraw from Africa, the Commission said, as soon as the African Development Bank (AfDB) is capable. The Commission says the World Bank should continue lending to poor countries in Eastern Europe, the former Soviet Union, and the non-oil Middle East.

The Commission proposes that the World Bank should be renamed the World Development Agency, reflecting its revised mission. It would provide grant-based assistance focused on global public goods – improvements in the environment, reduction of communicable diseases, etc. The regional banks would use the same grant procedures to fund activities such as rural health, education, and other poverty alleviation programs in poor and lower-middle income countries. These activities would be financed by increased flows of on-budget appropriations from the United States and other donor countries. The programs themselves would be administered by private or not-for-profit organizations, most likely under the supervision of national government agencies. The funds for their support would not go through government hands, however, and would be released only after the service has been provided.

Proposals for Change: The Clinton Administration

Secretary of the Treasury Lawrence Summers has articulated a different vision concerning the future of the international financial institutions. He would not reduce their operations as suggested by the Meltzer Commission, but would restructure and refocus their operations.

The Future of the IMF. Summers contends that the IMF is "indispensable," but that it needs to change the way it operates in order to reflect the new realities of the international financial system. In particular, he says, it should reflect and support the central role the private sector now plays in international finance. The Fund should provide more information about its operations and conditions in countries to markets and investors and it should encourage countries to comply with higher disclosure standards and to meet the new international codes and standards for sound monetary and fiscal practices. The Fund should pay closer attention to the financial vulnerability of countries, in advance of crises, helping them learn how to strengthen their foreign exchange regimes (in particular, how to avoid the risk inherent in pegged exchange rates) and how to improve the stability of their national financial institutions.

The IMF should focus on its core competency, Summers proposes. It should phase out its long-term financing programs and focus instead on immediate programs aimed at diffusing international financial crises. It should be the lender of last resort for countries in crisis and should not supplant the private sector. IMF conditionality should focus more narrowly on issues that are necessary and sufficient for restoring growth and financial stability. However, the IMF should also address key factors such as the need for strengthening a country's financial institutions, enhancing social cohesion, and improving countries' adherence to their contractual obligations.

The IMF should also put more emphasis, Summers argues, on growth and poverty alleviation. The Fund should continue to certify, before countries receive new debt relief or new infusions of concessional aid, that they have satisfactory macroeconomic policies. However, issues relating to the alleviation of poverty should be more central to the dialog between countries and the IMF than they have been in the past.

The IMF should also pay more attention, Summers says, to the issue of graduation. It should aim to reduce, over time, the number of countries that need the IMF. It should encourage them to adopt reforms and policies that will permit them to handle most financial crises (as do most developed countries today) without the direct intervention of the IMF.

The Future of the MDBs. Secretary Summers has called for a new division of labor between the IMF and the multilateral development banks. The IMF should focus on macroeconomic evaluations, the provision of information, and crisis lending. The World Bank should focus in its areas of strength, particularly poverty alleviation and development goals. The multilateral banks have no business lending in sectors, he says, where private financing is available on appropriate terms. Loans should be limited, in countries with market access, to activities that encourage increased inflows of private funds and programs – such as health, education, rural infrastructure, and institutional or policy reform – that are unlikely to be financed by the private sector. Counter-cyclical lending from the World Bank may also be needed to generate growth and recovery in situations where the flow of private sector funding has temporarily dried up because of financial shocks or contagion effects.

The MDBs should reward and encourage domestic efforts at reform, Summers says, rather than trying to force reforms into existence. There needs to be closer dialog between the banks and borrower countries about institutional capacity and the conditions on MDB loans need to focus on essential issues. The conditions the MDBs place on their loans should be fewer in number and more realistic. They should also be clear and measurable, so that everyone can determine whether benchmarks have been met. Countries should adhere more vigorously to those conditions. The banks should also be more transparent, he argued, so the public inside and outside the borrower countries, other foreign aid donors, and the private sector can more readily track the impact and results of bank operations. The MDBs need to be more selective in the kinds of things they finance, Summers maintains, and they need to be confident that their resources will be well used.

The MDBs should not expect that the capital resources they use for their non-concessional lending programs will necessarily be increased in the future. On the other hand, Summers argues, the United States and other donor countries need to increase the amounts of money they contribute to support the banks' concessional loan programs and their debt forgiveness operations. The multilateral banks need to coordinate and differentiate their activities and to improve their division of labor. The World Bank should take the responsibility for core program lending, he said, while the responsibility for other kinds of programs should be devolved to the regional banks in areas where they have proven expertise. The World Bank and the other MDBs should also put more emphasis on programs that address global public goods. In particular, Summers agreed that the World Bank should substantially increase the amount it lends each year from its concessional loan window to treat and combat the spread of infectious disease in the poorest countries. He also believes the MDBs should put additional emphasis on environmental problems, such as deforestation and global warming.

Comparing the Two Sets of Proposals

IMF Conditions and Eligibility. The Meltzer Commission and Administration both agree that the IMF should concentrate on the diffusion of financial crises and phase out its long-term lending programs. Both agree that the IMF should not supplant private lending, but rather it should lend in situations where private finance is no longer available. Both agree that the IMF should work to lessen the vulnerability of its member countries. The Meltzer Commission would do this through a requirement that countries may not borrow from the IMF unless they have already adopted major reforms in their financial systems. Secretary Summers is somewhat more subtle in his approach. He would not require countries to adopt specific reforms in advance. However, he would have the IMF urge countries to comply with new international codes and help them strengthen their national institutions and exchange rate policies. Because the IMF would also be releasing more information about its operations and conditions in countries, the private sector would be better informed and would likely charge higher rates before it would put money into countries with unsound policies and weak institutions.

The Meltzer Commission and Secretary Summers disagree, however, on a number of key points. The Commission wants the IMF to charge penalty interest rates – higher than those the country previously paid when it borrowed from private sources. Secretary Summers seems to agree that the IMF should charge higher rates, but he evidently does not agree that they should be higher than commercial rates. The Meltzer Commission seems to believe that – except for countries whose collapse might damage the world financial system – the IMF should be willing to deny credit to insolvent countries and countries that have not already adopted major reforms. Secretary Summers seems to believe that the IMF should be willing to lend even to countries whose governments have previously pursued unsound or unwise fiscal and monetary policies. The needed changes would be addressed through the conditions the IMF placed on access to its resources and its close monitoring of its loans.

MDB Lending. The Meltzer Commission and Secretary Summers both agree that the United States and other donor countries should increase the amount they contribute to fund the multilateral banks' concessional loan program. They also agree that the World Bank should put increased emphasis, through its concessional loans, on global public goods.

Their fundamental difference relates to their treatment of non-concessional MDB aid. The Commission says the MDBs should not make loans for any purpose to countries that have access to international capital markets. Secretary Summers argues, by contrast, that the MDBs should continue to fund projects for poverty alleviation, rural health and education, and institutional or policy reform. The Secretary and the Commission seem to disagree as to whether the market will readily finance these projects or whether governments will be willing to borrow money at commercial rates to fund projects of this sort. The benefits from these kinds of projects accrue to the public as a whole and may not be realized fully until several years in the future, well after payments would be due for the loan.

The Commission and the Secretary also disagree about the criteria the MDBs should use when making their loan decisions. The Commission seems to believe the key factor should be the most efficient allocation of capital to productive uses. Secretary Summers has argued that foreign policy considerations, broadly conceived, are an important element of the MDB program. The Commission argues that the MDBs should not be an instrument of foreign policy, an off-budget account to channel resources to countries of special concern or to support non-economic policy goals. The Secretary maintains that the MDBs make an important contribution to our national security. The United States has a strong interest in promoting growth and stability in developing countries. The involvement of the MDBs can help attract additional flows of private capital. The MDBs also give more attention than might be expected from the private sector to considerations such as the encouragement of political and economic reform, environment protection, and poverty alleviation.

Debt Forgiveness. Not mentioned above is the issue of debt forgiveness for poor countries. The Meltzer Commission and the Administration both agree that the international financial institutions should provide broad forgiveness of the debt owed to them by poor countries. (To qualify, countries would need to adopt economic reforms to make their economies more productive as well as policies to improve social welfare.). The Commission supports more forgiveness of these debts than the Administration and the international agencies are currently prepared to provide through the joint World Bank-IMF initiative for the cancellation of debt owed to them by the heavily indebted poor countries (the HIPC Initiative).

The Administration asked Congress to appropriate $247 million for FY2000 to fund a U.S. contribution to the HIPC Trust Fund (the mechanism for cancelling IFI debts.) It also asked Congress for permission to vote in favor of a proposal in the IMF authorizing the IMF to sell (and later repurchase)14 million ounces of gold to fund its share of the HIPC program. Congress gave the Administration authority to vote for the sale of 9 million ounces of gold (the rest to be requested in calendar 2000.) Congress did not appropriate any funds, however, for contribution to the HIPC trust fund. The Administration is seeking an appropriation of $150 million for FY2001.

The Meltzer Commission has not addressed how the expanded debt forgiveness for the HIPC countries should be paid for. This is perhaps the most contentious part of the issue. It appears that the Commission believes the IFIs can cancel the debt owed to them by the poor countries with their own resources. The Administration maintains that the IFIs do not have the resources to cancel this amount of debt without new contributions by donors to offset the debt or the use of money contributed for support of their concessional loan programs.

Issues for Further Consideration

Many of the differences between the recommendations of the Meltzer Commission and those of the Administration seem to stem from differences in philosophy or perspective. Others, however, seem open to empirical examination. For example, the Commission's proposal that the World Bank cease all lending in countries with access to capital markets, even for social programs and programs aimed at institutional or policy reform, is premised on an expectation that middle-income countries would be willing to borrow money abroad at commercial rates to finance these activities and the private sector would be willing to provide such funds. Congress might want to examine whether there are grounds to believe that countries would be willing to borrow funds for these purposes or whether a requirement for commercial financing would reduce their expenditures for social programs, institutional improvements, and policy reform.

Similarly, there may be grounds for a factual study of the terms for future IMF lending. The Commission and the Administration both maintain that the IMF should phase out their long-term lending programs in favor of short-term lending to restore financial stability in countries facing an international financial crisis. One member of the Commission (Mr. Levinson) indicated, however, that some countries may need longer than a year or 18 months to repay the IMF for such crisis loans. Congress might want to examine what provisions should be made, under either plan, to refinance IMF crisis loans. Is it likely that the private sector would provide long-term financing to help countries settle these debts? Should provision be made (at least for some countries) for the MDBs to refinance these loans, perhaps in the form of programs to finance basic reforms in countries' economies?

Congress might also want to examine whether the regional development banks have the resources, staff, and expertise to replace the World Bank as the primary development lender in their regions. In many respects, the lending programs of the Inter-American Development Bank and the Asian Development Bank are very similar to that currently funded by the World Bank. The ADB puts more emphasis on infrastructure and finance projects (60% of total lending in 1998) than does the World Bank's IBRD and IDA (36% of the total in 1999). The IDB seems to resemble the World Bank in this regard (30% of its lending in 1998 was for energy or infrastructure, though a major share of the 15% lent for the reform and modernization of state institutions seems also to have gone for financial programs.) Congress might want to inquire whether the goals of the Meltzer Commission will be advanced if the locus of MDB lending in Asia and Latin America were shifted from the World Bank to the regional banks.

Some thought might also be given to the procedures through which the IMF and the multilateral banks coordinate their activities in either the scenario proposed by the Commission or by Secretary Summers. In recent crises, the IMF has taken the lead in negotiating strategies with the borrower country. Structural reform has frequently been the centerpiece of these strategies, but the multilateral banks did not participate directly in the talks. They had the principal responsibility later, however, for the design and implementation of the projects which sought to effect those reforms. Under either scenario, the IMF would focus primarily on the immediate financial crisis. The policies a country adopts in response to that crisis, however, may have long-term implications for its future development. Would the IMF take these considerations into account? Should the MDBs undertake parallel negotiations with countries during the crisis period to deal with the long-term implications? Should the MDBs wait to involve themselves in post-crisis development activity until after the crisis has been resolved? The functions of the IMF and World Bank would be more clearly defined and differentiated under both scenarios. However, they would both be working with the same country. What happens if the conditions on IMF loans conflict with the conditions the MDBs place on their development loans? Will such conflicts be resolved in a transparent or a confidential manner? Congress might want to examine how the operations and policies of the IMF and multilateral banks would be coordinated if major reforms of the types proposed by the Commission and Secretary Summers were adopted.

Finally, Congress might want to examine the basic figures on World Bank lending reported by the Meltzer Commission. The numbers on the amount of World Bank assistance going to support private sector activity includes the total for IFC loans and equity investments, IBRD and IDA loan guarantees, and the face value of MIGA loans. However, these comprise a relatively small amount of money compared to the total annual volume of IBRD and IDA loans. It appears, from inspection, that a minority of the activities cited by the Meltzer commission report as being "directly profitable to the private sector" are actually operated by private firms. Rather, activities are included in this category if they could be undertaken by private sector firms or managed by private contractors at the behest of government agencies. Many of the projects included in this category (major roads and highways, bridges, water and sewerage facilities, irrigation systems, and railroads) are often funded and operated by government agencies in the United States and other developed countries. Some loans for institutional reform, privatization, and the closure of money-losing state firms may also have been included in the total. The principal point of these figures – that the MDBs are funding activities that could be undertaken by private firms – may be correct. However, the percentages cited in the Meltzer Commission report may be subject to change if different standards are used for categorizing the projects.